**Committee Name:** **Local Tax Modernization Subcommittee**

**Members:**
**Mr. Rusty Harris: Chairman**
**Rep. Becky Carney/ Oversight Co-Chair**
**Sen. Dan Clodfelter**
**Mr. Joe Carpenter**
**Mr. Keith Criscoe**
**Mr. Terry Garrison**

**Meetings:**
**December 19, 2006**
**January 17, 2007**
**January 29, 2007**
**February 19, 2007**

## I. Brief review of the subcommittee's charge

Our charge:

1. Determine whether the portfolio of taxes and fees and mix of revenue sources at the local level is appropriate.
2. Examine and evaluate local governments' ability to pay for services required by their citizens.
3. Review the following taxes and fees to determine whether any changes are needed to align the revenue sources in accordance with the general tax principles set out below:
    a. Sales taxes
    b. Property taxes
    c. Real estate transfer taxes
    d. Impact fees
    e. Vehicle use fees.

4. Identify ways to broaden the tax base, lower tax rates, and eliminate special exemptions and rates consistent with the tax principles.

## II. Issues dealt with over the last two months

1. Assessing the future needs of local governments. We primarily looked at needs associated with Education (current & capital), Medicaid, and Public Safety.
2. Based on revenue growth projections for local governments, we evaluated local governments' ability to pay for future needs
3. Examining revenue options available to local governments.

## III. Speakers providing information to the subcommittee and a summary of the presentations

Mr. Mike Walden, Professor, N. C. State University

1. Summary of total revenue by source for Wake and Bertie Counties. This presentation provided insight as to how much revenue was coming from different sources in two different counties, one urban, one rural.
2. An analysis of property tax revenue as a percentage of total personal income for all counties.
3. A listing of local sales tax exemptions and services requiring licenses.
4. Presentation of the impact of various taxing options using the "tax calculator"

Mr. Jan Winters, County Manager, Gaston County

1. Spreadsheet comparing the projected growth in property tax and sales tax revenue to the projected increases in current expenses for education, debt service on capital expenses for education, and projected Medicaid expenses over the next five years.

## IV. Specific recommendations (with a discussion of the reasoning and explanation for those recommendations)

1. Determine whether the portfolio of taxes and fees and mix of revenue sources at the local level is appropriate.

   Currently, local governments depend primarily on property taxes and sales taxes for their revenues. While these taxes may be appropriate for some local governments, the needs of communities in North Carolina vary greatly. For example, high growth communities often are in need of more infrastructure, while other areas may have high operating costs associated with Medicaid. The revenue options available today do not provide enough flexibility for local governments to meet the needs of its citizens. A limited number of counties have received approval from the legislature to utilize additional taxes and fees such as real estate transfer taxes, prepared food taxes, occupancy taxes, and impact fees. These additional revenue options have given this limited number of local governments' flexibility to address their local needs.

**Recommendations:**

Local governments need greater flexibility with taxing options in order to meet their needs going forward. A menu of taxes and fees should be available to local governments and should be consistent across the state. The menu should include, but not be limited to, options for sales taxes, real estate transfer taxes, impact fees, and vehicle use taxes. Additionally, should local governments be given the opportunity to fund road construction projects locally, a revenue sharing option for the gasoline tax should be considered. The legislature should set broad parameters for the appropriate use of these new options and identify an entity, such as the Local Government Committee, to provide oversight to local governments.
The state should also provide greater flexibility for the use of local tax revenues by lifting some mandates that earmark revenues.

2. Examine and evaluate local governments' ability to pay for services required by their citizens.

Since the primary source of revenue for local governments is property tax, to a great extent, local governments' ability to pay for services required by their citizens is determined by the property values in their jurisdictions. Property values vary greatly across the state; therefore the revenue stream from property values varies greatly. Even with high property tax rates, low real estate wealth counties struggle today to meet the needs of their citizens, in part because of the disproportionately high Medicaid expenses in those areas. Additionally, for most counties the rate of growth of locally funded education expenses (both current expenses and capital expenses) and Medicaid expenses far exceed the rate of growth of property tax and sales tax revenue. Based on information presented to the subcommittee, the growth in local sales and property tax revenues over the next five years falls short of projected increases in Medicaid and education expenses by $2.0-$2.5 billion, and up to $3.5 billion if increased public safety expenses are included. Therefore, local governments already struggling to meet the needs of their citizens will find it even more difficult in the future, and more local governments that are currently able to meet their needs will be unable to do so in the future.

3. Review the following taxes and fees to determine whether any changes are needed to align the revenue sources in accordance with the general tax principles set out below:
    a. Sales taxes
    b. Property taxes
    c. Real estate transfer taxes
    d. Impact fees
    e. Vehicle use fees.

4. Identify ways to broaden the tax base, lower tax rates, and eliminate special exemptions and rates consistent with the tax principles.

    <u>Sales taxes</u>

    Sales taxes represent the best opportunity to broaden the tax base and lower tax rates. Since sales taxes currently only apply to goods, taxing services would significantly broaden the tax base. Based on the "tax calculator" model used by the subcommittee, taxing all services would increase revenues at the local level by approximately 50% if the sales tax rates remain at the current level. A sales tax rate of 1.25% on all services and all currently taxed goods would yield an increase in local revenues of about 10%. Alternatively, taxing all services, excluding housing, could allow property taxes to be reduced by one-third. Our subcommittee looked at two counties with significantly different characteristics, Wake and Bertie, and found that broadening sales taxes to include services resulted in a similar percent increase in sales tax revenue for each county. Clearly, broadening the sales tax base to include services would give local governments flexibility they don't currently have to meet rising costs or provide property tax relief.

    **Recommendation**:

    Sales taxes should be broadened to include services. An earned income tax credit targeted towards low income households should be developed if sales taxes are applied to housing and groceries.
    Two additional issues warrant further consideration: 1.) The distribution of sales tax revenues should be reviewed potential inequities, and 2.) lost revenue associated with internet sales should be addressed through federal regulation.

Property Taxes

Property taxes provide a relatively steady revenue stream and thus are an important part of the tax structure Property tax rates vary greatly between counties because of the variation in value of the underlying property. The result is a perception of inequity because of the wide variation in rates from county to county; however, the variation in taxes as a percent of income doesn't vary as much. In areas of high property value appreciation, property taxes put a hardship on fixed income residents, which is an issue that can be addressed. Additionally, exemptions from property taxes for industries can be a source of inequity.

**Recommendations:**

Consideration should be given to affording local governments with additional options related to property taxes:
**Tax deferral for elderly or fixed income residents** – this would allow the counties to place a lien on property in lieu of tax collections. The tax collection would take place when the property is sold. Income eligibility should be used as criteria for tax deferral.
**Annual indexed revaluation** – currently counties may revalue property every year, however, revaluation is costly and is typically done on a cycle ranging between four and eight years. Annual indexing would help local governments cost effectively recognize the true market value of new growth and, therefore, allow new growth to better contribute toward the costs of new infrastructure. Local governments that choose to use annual indexing should be required to perform property assessments a maximum of every four years.

Additionally, property tax exemptions should be reviewed to ensure the proper balance of maintaining a "pro business" climate with the equity issues of everyone paying their fair share.

Real Estate Transfer Taxes

Real estate transfer taxes are a version of a "sales tax" on real estate and are used as an alternative to higher property tax rates. Many states use real estate transfer taxes as a source of tax revenue. Given the wide range of value on real estate transactions, most states limit real estate transfer taxes to 1% or less and place a cap on the tax on our per transaction basis. Such a tax should be kept small so as not to impede the transfer of property.

**Recommendation:**

Real estate transfer taxes should be one of the options given to local governments. However, real estate taxes should be designed so as not to impede the transfer of property. A study should be commissioned to determine the appropriate rates, caps, and exclusions. Additionally, it would be appropriate for tax revenues from real estate taxes to be targeted towards expenses that generally increase the value of property, such as local infrastructure.

<u>Impact Fees</u>

A small number of counties in North Carolina currently have impact fees as an option. It is primarily a benefit in high growth counties. Impact fees should be available as an option, and like real estate transfer taxes, the fee should be capped and revenues targeted towards costs that generally increase the value of property.

<u>Vehicle Use Tax</u>

A $10 per year vehicle use tax would yield about a 1% increase in local tax revenue. Authority should be given to all municipalities to set the vehicle use tax at the same level.

## V. Issues yet to be reviewed by the subcommittee including a plan for addressing those issues

None.

## VI. Other matters that you would like to bring before the full commission

The subcommittee identified two other issues that warrant consideration. First, the need for infrastructure at the local level is great in the years to come. The state should encourage an integrated capital spending plan to ensure that the highest priority needs are being addressed.
Secondly, in order to meet the significant financial needs of the future, local governments should consider greater consolidation of services to ensure that services are being delivered as efficiently as possible. Counties should work together to create regional means of delivering

services. For example, regional court systems and regional school districts could more efficiently serve the citizens than we do today.